

ORIGINAL



0000100114

RECEIVED

2009 JUN 29 P 2:12

AZ CORP COMMISSION
DOCKET CONTROL

FENNEMORE CRAIG, P.C.
Patrick J. Black (No. 017141)
3003 N. Central Ave.
Suite 2600
Phoenix, Arizona 85012

SALLQUIST DRUMMOND & O'CONNOR, P.C.
Richard L. Sallquist
1430 E. Missouri, Suite B-125
Phoenix, Arizona 85014
Attorneys for H2O, Inc.

BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF H2O, INC. FOR A DETERMINATION
OF THE CURRENT FAIR VALUE OF ITS
UTILITY PROPERTY AND FOR AN
INCREASE IN ITS WATER RATES AND
CHARGES FOR UTILITY SERVICES.

DOCKET NO: W-02234A-07-0557

Arizona Corporation Commission

DOCKETED

JUN 29 2009

DOCKETED BY

**H2O, INC.'S
REPLY CLOSING BRIEF**

June 29, 2009

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

TABLE OF CONTENTS

| | Page |
|------------------------------------|-------------|
| I. RATE BASE ISSUES..... | 1 |
| II. TERMINATION OF CRC TARIFF..... | 3 |
| III. RATE DESIGN..... | 4 |
| IV. CONCLUSION..... | 4 |

1 INTRODUCTION

2 H2O, Inc. ("H2O" or the "Company") hereby submits this Reply Closing Brief in
3 the above-captioned matter. As more fully addressed herein, the Company asserts that:
4 (1) Staff's application of unexpended funds as contributions in aid of construction
5 ("CIAC") and advances in aid of construction ("AIAC") to the Company's rate base
6 (resulting in a negative rate base) is a classic example of a 'mismatch' and does not reflect
7 traditional ratemaking; (2) Staff's concerns regarding the Company's capital structure are
8 better addressed by increasing cash flow available for reinvestment in plant than through
9 the elimination of H2O's Off-Site Capacity Reservation Charge Tariff ("CRC Tariff");
10 and (3) the minor difference in rate design as proposed by the Company provides a greater
11 degree of revenue stability, which is important to a utility like H2O.

12 I. RATE BASE ISSUES

13 In its Initial Closing Brief, Staff relies on the pre-filed testimony of Mr. Aladi to
14 support its proposal to apply unexpended funds as CIAC and AIAC to the Company's rate
15 base, even though there is no corresponding plant in service. Staff Initial Closing Brief
16 ("Staff Brief") at 2-4. However, when cross-examined during the hearing about his pre-
17 filed testimony and the reasons behind Staff's proposal, Mr. Aladi made several
18 concessions that demonstrate why his pre-filed testimony was misguided.¹ He agreed that
19 H2O does not have 'use' of the unexpended funds, and that they are restricted for the cost
20 of future infrastructure to serve developments on an individual, project-specific basis.
21 Hearing Transcript ("TR") at 108-109. He agreed that the underlying reason there is a
22 deduction of CIAC from rate base in Form Schedule B-1 (A.A.C. R14-2-103, Appendix
23 B) is because there is a **logical connection between CIAC and plant-in-service**. TR at
24 117. And finally, he agreed that the Company's request that the unexpended funds be

25 ¹ Notably, Staff failed to cite any testimony from the hearing transcript in support of Mr. Aladi's
26 pre-filed testimony, which was thoroughly addressed on cross-examination.

1 added to rate base was immaterial to the ratemaking analysis. TR at 136. Clearly,
2 Mr. Aladi's pre-filed testimony does not support the conclusions and recommendations
3 contained in Staff's Brief.

4 Staff suggests that the Company's position would not recognize the origin of the
5 unexpended funds. Staff Brief at 3. This demonstrates a fundamental misunderstanding
6 of H2O's position on rate base. The Company agrees that funds provided by a third-party
7 developer should be applied as CIAC, which results in a subtraction from rate base value,
8 *but only when there is a corresponding addition to plant in service that is built with those*
9 *funds*. Otherwise, the result is a classic regulatory mismatch, as illustrated in the example
10 provided in **Exhibit 1** hereto. As this example shows, applying CIAC in the manner
11 proposed by Staff no longer makes it revenue neutral. This does not reflect traditional
12 ratemaking.

13 Staff also suggests that the "surplus of advanced and contributed funds is a
14 reflection of the extraordinary growth that H2O has benefited from without having to
15 supply its own investment in order to serve." *Id.* at 4. H2O fails to see where it has
16 benefited as no benefit exists. It has no use of the funds, other than to build off-site
17 infrastructure specifically earmarked and tied to those funds. TR at 108-109. When the
18 funds are actually spent, there will be no excess earnings because the corresponding plant
19 will be constructed using zero-cost capital. TR at 120-121; *see also* Bourassa RJD at 4-5.
20 The Company does not earn a return on and of CIAC-funded plant, and customers enjoy
21 lower rates as a result. In reality, maintaining a surplus of advanced and contributed funds
22 is a liability, not a benefit, if those unexpended funds are used to artificially reduce the
23 Company's rate base in the manner proposed by Staff. Again, Staff's proposed
24 adjustments fail to recognize the logical connection between CIAC and plant-in-service.

25 For these reasons, H2O requests that the Commission adopt the Company's
26 proposed FVRB of \$1,996.695.

1 **II. TERMINATION OF CRC TARIFF**

2 In its brief, Staff expresses serious concerns over H2O's current capital structure,
3 which is heavily reliant on contributed plant, and the long-term effects this has on the
4 Company's ability to invest returns on and of its investment in plant. Staff Brief at 4.
5 However, Staff concedes that elimination of the CRC Tariff will not resolve this issue. *Id.*
6 at 7. Company witness Thomas Bourassa testified that the current imbalance in H2O's
7 capital structure at this time is the result of a timing problem. TR at 55-56. Staff appears
8 to discount Mr. Bourassa's testimony because even if the Company's proposed fair value
9 rate base of \$1,995,695 is accepted, it would represent only fifteen percent (15%) of the
10 total \$13 million plant in service. *Id.*

11 H2O submits that a 15% equity ratio places the Company in a far better position to
12 attract capital investment or debt than the negative rate base proposed by Staff. Granted,
13 this amount is still disproportionately low, but any positive adjustment to rate base and
14 any improvement in the capital structure, no matter how small, is nonetheless a step in the
15 right direction to address Staff's concerns. But capital structure – debt and equity – is not
16 the salient issue in this proceeding. TR at 64-65. Nonetheless, as Mr. Bourassa pointed
17 out during his testimony, once growth returns and the Company begins to build the off-
18 site infrastructure needed to serve such growth, it will require equity investment (or debt)
19 because the amount of funds recovered through the CRC Tariff will not cover the entire
20 cost to build such plant. TR at 55-56.

21 Elimination of the CRC Tariff is not appropriate at this time. The Company's
22 capital structure – and how to bring it more in line with traditional utilities – is an issue
23 that is not a subject in this proceeding and should be addressed in a future rate proceeding.
24 As Staff suggests, it will take more than simply terminating this hook-up fee to resolve
25 long-term issues related to capitalization. Therefore, H2O asserts that the fair and
26

1 equitable approach is to address all such issues in a later proceeding, not in piecemeal
2 fashion.

3 **III. RATE DESIGN**

4 Both the Company and Staff agree that a rate design structured to encourage
5 conservation is appropriate. The main difference includes that proportion of revenue that
6 is collected through the monthly minimum charge, versus that portion collected through
7 the commodity charge. The Company is proposing that 44% of its revenue requirement
8 be recovered through the fixed minimum, while Staff is proposing a percentage closer to
9 35%. TR at 32. Currently, the Company recovers approximately 45% of its revenue
10 requirement from monthly minimum charges. Simply put, the disagreement between the
11 Company and Staff is over striking a proper balance between revenue stability and water
12 conservation goals. H2O asserts that its proposal, which is consistent with the Company's
13 current rate design, strikes that appropriate balance by still sending appropriate water
14 conservation signals without jeopardizing revenue stability.

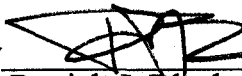
15 **IV. CONCLUSION**

16 Despite Staff's concerns over the Company's capital structure and over-reliance on
17 contributed plant, H2O customers will still experience a rate reduction as a result of this
18 rate proceeding. If the Company had the means to improve its capital structure into the
19 range recommended by Staff (between 40 to 60 percent equity), then the central issue in
20 this proceeding would be rate shock. Clearly, a gradual reduction in the percentage of
21 contributed plant would allow both shareholders and ratepayers to move the Company
22 towards a more financially viable entity without a sudden sizeable increase in rates.
23 Unfortunately, Staff's proposals on rate base and the elimination of the CRC Tariff would
24 move the Company in the wrong direction towards improving its capital structure, and
25 would make the task of attracting private equity, or acquiring reasonably-priced debt,
26 more daunting than it already is. For the reasons stated above, H2O respectfully requests

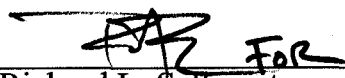
1 that adopting its own proposals concerning those issues still in dispute with Staff are in
2 the public interest.

3 RESPECTFULLY SUBMITTED this 29th day of June, 2009.

4 FENNEMORE CRAIG, P.C.

5
6 By 
7 Patrick J. Black
8 3003 North Central Avenue, Suite 2600
9 Phoenix, Arizona 85012
10 Attorneys for H2O, Inc.

11 SALLQUIST, DRUMMOND & O'CONNOR, P.C.

12 By 
13 Richard L. Sallquist
14 1430 E. Missouri, Suite B-125
15 Phoenix, Arizona 85014
16 Attorneys for H2O, Inc.

17 **ORIGINAL** and thirteen (13) copies
18 of the foregoing were filed
19 this 29th day of June, 2009 with:

20 Docket Control
21 Arizona Corporation Commission
22 1200 West Washington
23 Phoenix, Arizona 85007

24 **COPY** was hand-delivered
25 this 29th day of June, 2009 to:

26 Dwight Nodes, ALJ
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

1 Charles Hains
Legal Division
2 Arizona Corporation Commission
1200 West Washington
3 Phoenix, Arizona 85007

4 Ernest Johnson
Utilities Division
5 Arizona Corporation Commission
1200 West Washington
6 Phoenix, Arizona 85007

7

8 By: Marion San Jose

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

26

Exhibit 1

Illustration of Mismatched and Matched Rate Base
for unexpended CIAC cash received and committed to fund
future plant for future customers

| | Simplified Balance Sheet | [1] Simplified Rate Base (Mismatched) | [2] Simplified Rate Base (Matched) |
|---|-----------------------------|--|---|
| Cash (Unexpended CIAC portion) ¹ | \$ 100 | | |
| Plant-in-service, net | \$ - | \$ - | \$ - |
| Total Assets | <u>\$ 100</u> | | |
| | Less: | | |
| Contributions-in-aid of Construction ("CIAC") (unexpended portion) | \$ 100 | \$ (100) | \$ - |
| Equity | \$ - | | |
| Total Liabilities and Equity | <u>\$ 100</u> | <u>\$ (100)</u> | <u>\$ -</u> |
| Incremental Revenue Requirement Impact | | | |
| Assumed Required ROR | | 10% | 10% |
| Impact on Revenues ⁴ | \$ | \$ (10.00) | \$ - |
| Depreciation and Amortization Impact ⁵ | | (3.50) | - |
| Income Tax Impact ⁶ | | (5.40) | - |
| Impact on Revenue Requirement | \$ | <u>\$ (18.90)</u> | <u>\$ -</u> |

¹ Cash received from contributions which is committed to fund future plant-in-service for future customers.

² Net Rate Base reflects the net investment on which the customers (rate payers) must pay a rate of return, or the total of the investment made by the owners and creditors in plant and other items to enable the utility company to render service to the customers.

³ Rate Base [1] is unbalanced and a mismatch occurs between rate base, revenues and expenses since there is no corresponding investment in plant-in-service for the unexpended cash. Rate Base [2] is a negative, the impact on revenues is negative (negative return \$'s), and the impact on operating expenses (depreciation) is negative. Existing customers receive a windfall. In rate making, CIAC is revenue neutral. In other words, it has a net zero impact on rate base, revenues and operating expenses (no depreciation). This is why off-site hook-up fees (CIAC) can be approved outside the context of a rate case. Rate Base [2] is balanced and no mismatch is present. Rate base, revenues and expenses are properly matched. Rate Base [2] is zero, the impact on revenues are zero (no return \$'s), and the impact on operating expenses (depreciation) is zero.

⁴ Rate Base times Rate of Return

⁵ Amortization of CIAC is an offset to depreciation expense. Assumed composite depreciation rate of 3.5%. Depreciation and Amortization equals Plant-in-service times 3.5% less CIAC times 3.5%.

⁶ Assumes 40% tax rate.